(2)

Supreme Court, U.S.
FILED
NOV 19 1997
CLERK

No. 97-511

In the Supreme Court of the United States

OCTOBER TERM, 1997

RHOADES OIL COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

SETH P. WAXMAN
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

KENNETH L. GREENE
THOMAS J. CLARK
Attorneys

Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

13 pp

QUESTION PRESENTED

Whether an oil and gas producer's "lifting costs" must be subtracted from its gross receipts to arrive at its "gross income" for purposes of determining liability for the personal holding company tax imposed by Section 541 of the Internal Revenue Code of 1986, 26 U.S.C. 541.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	1
Argument	4
Conclusion	9

TABLE OF AUTHORITIES

Cases:

Auer v. *Robbins*, 117 S. Ct. 905 (1997)	6
Bowles v. *Seminole Rock & Sand Co.*, 325 U.S. 410 (1945)	6
Commissioner v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955)	7
Commissioner v. *Jacobson*, 336 U.S. 28 (1949)	7
Commissioner v. *Schleier*, 515 U.S. 323 (1995)	7
Edenfield v. *Commissioner*, 19 T.C. 13 (1952)	5
Laguna Royalty Co. v. *Commissioner*, 406 F.2d 703 (5th Cir. 1969), aff'g 27 T.C.M. (CCH) 164 (1968)	3, 6, 8
Max Sobel Wholesale Liquors v. *Commissioner*, 630 F.2d 670 (9th Cir. 1980)	4
O'Gilvie v. *United States*, 117 S. Ct. 452 (1996)	7
Security Services, Inc. v. *Kmart Corp.*, 511 U.S. 431 (1994)	6
Stinson v. *United States*, 508 U.S. 36 (1993)	6
Udall v. *Tallman*, 380 U.S. 1 (1965)	6
United States v. *Burke*, 504 U.S. 229 (1992)	7
Woodside Acres, Inc. v. *Commissioner*, 134 F.2d 793 (2d Cir. 1943), aff'g 46 B.T.A. 1124 (1942)	5

Statutes and regulations:	Page
Internal Revenue Code of 1986 (26 U.S.C.):	
§ 61	3, 4, 5
§ 162	8
§ 541	1
§ 542	2
§ 542(a)(1)	6
§ 543(a)	2
§ 543(b)	2, 3
Treas. Reg. (26 C.F.R.):	
§ 1.542-2	4, 5
§ 1.61-3	3
§ 1.61-3(a)	4, 5
Miscellaneous:	
B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* (6th ed. 1997)	6
Rev. Rul. 60-344, 1960-2 C.B. 186	3, 5-6
Statement of Financial Accounting Standards No. 19: Financial Accounting and Reporting by Oil and Gas Producing Companies, reprinted in FASB, *Original Pronouncements* (1995/96 ed.)	8
H. Williams and C. Meyers, *Oil and Gas Terms* (1987)	8

In the Supreme Court of the United States

OCTOBER TERM, 1997

No. 97-511

RHOADES OIL COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinions of the court of appeals (Pet. App. A1-A3) and of the district court (Pet. App. A4-A25) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on June 19, 1997. The petition for a writ of certiorari was filed on September 17, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Section 541 of the Internal Revenue Code of 1986 (the Code), 26 U.S.C. 541, imposes a special tax on the "undistributed personal holding company income" of any "personal holding company." Under Section

542 of the Code, a corporation will generally be classified as a "personal holding company" if (i) more than half of its stock is held by five or fewer individuals, and (ii) 60 percent or more of its "adjusted ordinary gross income" is "personal holding company income." Section 543(b) defines "adjusted ordinary gross income" by providing for certain exclusions from, and adjustments to, "gross income," which is not further defined in the personal holding company provisions of the Code. Section 543(a) defines "personal holding company income" as the portion of "adjusted ordinary gross income" that is derived from certain typically passive sources, such as dividends, interest, rents, and royalties, rather than from the active conduct of a trade or business.

2. Petitioner is a closely-held corporation that derives part of its income from the business of locating and producing oil and gas, and part from passive investments such as bonds and publicly traded stocks. Pet. App. A5-A6. In computing its tax liability for 1988, 1989, and 1990, petitioner took the position that the "gross income" used as the starting point for the personal holding company calculations under Section 543(b) of the Code included its gross receipts from oil and gas sales, without reduction for the operating or "lifting" costs incurred in producing the oil and gas sold.[1] Pet. App. A8. On that assumption, petitioner's "personal holding company income" (primarily dividends and interest derived from its

---

[1] "Lifting" costs are those production expenses incurred after the completion of drilling but before removal of the oil or gas from the well site for sale or transportation, including labor, supplies, maintenance, and applicable overhead costs. Pet. App. A8 n.***.

stock and bond investments) amounted to less than 60% of its "adjusted ordinary gross income" for the years in question, and petitioner's returns reflected no liability for personal holding company tax. *Ibid.*

On audit, the Internal Revenue Service (Service) determined that, in arriving at its "gross income" for purposes of Section 543(b), petitioner was required to reduce its gross receipts from oil and gas sales by the associated lifting costs. Pet. App. A8-A9. On that basis, petitioner's "personal holding company income" amounted to considerably more than 60% of its "adjusted ordinary gross income" for each of the years at issue. See *id.* at A2, A9; Gov't C.A. App. 28-30. The Service therefore determined that petitioner was liable for personal holding company taxes totaling $408,633 for the three years in dispute. Pet. App. A7. After paying the amounts assessed, petitioner brought this suit in the district court seeking a refund on the ground that the Service had employed an improper measure of "gross income."

3. The district court granted summary judgment for petitioner. Pet. App. A4-A26. The court rejected the Service's reliance on *Laguna Royalty Co.* v. *Commissioner*, 406 F.2d 703 (5th Cir. 1969), aff'g 27 T.C.M. (CCH) 164 (1968), and on Rev. Rul. 60-344, 1960-2 C.B. 186, on the ground that both had involved tax years that pre-dated amendments made to the personal holding company provisions in 1964. Pet. App. A14-A21. The court further held (*id.* at A22-A24) that Section 61 of the Code, which defines gross income generally, and 26 C.F.R. 1.61-3, which deals with gross income derived from business, were best interpreted to treat all gross receipts from oil and gas sales as part of gross income, with lifting (and other)

costs deducted later in the computation of taxable income.

4. The court of appeals reversed. Pet. App. A1-A3. In a brief unpublished opinion, the court concluded that, after "carefully review[ing] the submissions of the parties," it was "persuaded that lifting costs are analogous to costs of goods sold and properly excluded in arriving at gross income, and hence adjusted gross ordinary income, for purposes of the personal holding company tax." *Id.* at A2. In support of that conclusion, the court observed (*ibid.*) that 26 C.F.R. 1.61-3(a) states the general rule that "gross income" is equal to total sales less the cost of goods sold. The court also noted that 26 C.F.R. 1.542-2, promulgated to implement the Code's personal holding company tax provisions, refers to Section 61 of the Code, and the regulations thereunder, for the definition of "gross income," and specifically points out that "gross income is not necessarily synonymous with gross receipts." Pet. App. A2-A3.

ARGUMENT

1. The court of appeals correctly held that an oil or gas producer's "lifting" costs must be subtracted from its gross sales receipts in order to determine its "gross income" for purposes of the personal holding company tax. That decision accords with the well established principle that a business taxpayer's "gross income" is equal to its gross receipts less its cost of goods sold. See, *e.g.*, 26 C.F.R. 1.61-3(a) ("In a manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold."); *Max Sobel Wholesale Liquors* v. *Commissioner*, 630 F.2d 670, 671 (9th Cir. 1980) ("The very definition of 'gross income' has been thought to man-

date the exclusion of certain amounts (*e.g.*, the cost of goods sold) from that figure, even in the absence of specific statutory authority for such exclusion."); *Woodside Acres, Inc.* v. *Commissioner*, 134 F.2d 793 (2d Cir. 1943), aff'g 46 B.T.A. 1124 (1942) (dairy's gross income determined by subtracting cost of producing milk from gross receipts); *Edenfield* v. *Commissioner*, 19 T.C. 13, 22 (1952) ("But it seems to us that [taxpayer] confuses gross receipts with gross income and obviously the two are not the same.").[2]

That principle applies in the context of the personal holding company tax. Section 1.542-2 of the Treasury Department's regulations, 26 C.F.R. 1.542-2, refers to Section 61 of the Code and the regulations thereunder, including 26 C.F.R. 1.61-3(a) (quoted above), for the definition of "gross income," and it specifically cautions that "[u]nder such provisions gross income is not necessarily synonymous with gross receipts." The Department has long interpreted those regulations as requiring an oil and gas producer to subtract its lifting costs from its gross receipts to arrive at gross income for purposes of determining liability for the personal holding company tax. Rev. Rul.

---

[2] Petitioner argues at some length (Pet. 14-18) that the court of appeals erred by relying on 26 C.F.R. 1.61-3(a), which refers to "mining," in a case involving oil and gas production. The court of appeals did not, however, hold that production of oil or gas is "mining" for purposes of that regulation. The court correctly relied on Section 1.61-3(a) as an authoritative statement of the "general rule" that "gross income" means "total sales less the costs of goods sold"; it then held that "lifting costs are *analogous* to costs of goods sold * * * for purposes of the personal holding company tax," and it applied the general principle of Section 1.61-3(a) to this particular context by analogy. Pet. App. A2 (emphasis added).

60-344, 1960-2 C.B. 186; see *Laguna Royalty Co.* v. *Commissioner*, 406 F.2d 703 (5th Cir. 1969), aff'g 27 T.C.M. (CCH) 164 (1968). Unless the Department's interpretation of its own regulations is plainly inconsistent with the statute or the text of the regulations, it is entitled to "controlling weight." *Security Services, Inc.* v. *Kmart Corp.*, 511 U.S. 431, 436 n.2 (1994); see also, *e.g.*, *Auer* v. *Robbins*, 117 S. Ct. 905, 911 (1997); *Stinson* v. *United States*, 508 U.S. 36, 45 (1993); *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965); *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945).

As the court of appeals recognized (Pet. App. A3), the Service's position in this case "is supported by the regulations relied upon and is reasonable." The original purpose of the personal holding company tax was to discourage the use of closely held corporations for abusive purposes such as deriving and accumulating passive investment income (which might be taxed to the corporation at a rate lower than the marginal rate applicable to individual taxpayers). See generally, *e.g.*, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 7.20 (6th ed. 1997). That purpose would be easily frustrated if a taxpayer could cause the corporation to fail the 60% test of Code Section 542(a)(1) by including within the corporate shell a business with large gross receipts, even though the true gross income from that business (*i.e.*, gross receipts less costs directly attributable to the product sold, but before deduction of general expenses such as sales and administrative costs) might represent a much smaller fraction of the corporation's overall gross income. In this case, for example, petitioner's 1989 corporate tax return reflects gross receipts from oil and gas working interests of $1,211,825, but a "gross profit" (receipts

less lifting costs and certain other allowable costs) of only $445,459. Gov't C.A. App. 19, 21; see also *id.* at 28. The same return reflects gross interest and dividend income of $1,264,893. *Id.* at 19. There is nothing surprising or improper about the Service's application of the personal holding company provisions to such a situation.

2. Petitioner argues (Pet. 6-7) that the court of appeals' summary order in this case conflicts with the principle, set out in various cases, that exclusions from gross income are to be narrowly construed. The cases petitioner cites, however, all presented questions concerning whether particular items of income were to be included in gross income, and therefore subjected to tax, at all. See *O'Gilvie* v. *United States*, 117 S.Ct. 452 (1996) (punitive damages); *Commissioner* v. *Schleier*, 515 U.S. 323 (1995) (damages for age discrimination); *United States* v. *Burke*, 504 U.S. 229 (1992) (backpay award); *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955) (punitive damages); *Commissioner* v. *Jacobson*, 336 U.S. 28 (1949) (discharge of indebtedness). This case, by contrast, involves only whether certain expenses are to be taken into account at the outset in computing "gross income," or later by deducting them from gross income in order to compute taxable income. The issue is therefore not what income will ultimately be subject to tax, but what measure of "gross income" is most appropriately used to compare petitioner's income from active business operations to its income from passive investments such as stocks and bonds for purposes of deciding whether or not to impose on petitioner the special personal holding

company tax. None of the cases petitioner cites speaks to that issue.[3]

Petitioner identifies no conflict on the issue actually presented in this case, and we are aware of none. To the contrary, the decision below joins both the Tax Court and the only other federal court of appeals that has considered the issue in rejecting the result for which petitioner contends. See Pet. App. A2; *Laguna Royalty Co.*, *supra*. In the absence of any conflict, the matter plainly does not warrant this Court's review.

---

[3] Petitioner argues (Pet. 12-14) that the logic of the decision below would permit an oil or gas producer to subtract all of its ordinary business expenses from gross receipts to determine gross income, rather than deducting them from gross income, under Section 162 of the Code, in order to determine taxable income. That is not correct. The order below refers only to "lifting costs" (Pet. App. A2), a term with well understood contours—and limits—in the relevant industry. See, *e.g.*, *id.* at A8 n.*** (district court opinion); H. Williams & C. Meyers, *Oil and Gas Terms* 520 (1987); Financial Accounting Standards Board (FASB), *Statement of Financial Accounting Standards No. 19: Financial Accounting and Reporting by Oil and Gas Producing Companies* ¶¶ 12 ("[P]roduction (lifting) costs become part of the cost of oil and gas produced."), 24-25 (defining "production costs (sometimes called lifting costs)"), reprinted in FASB, *Original Pronouncements* 226, 229-230 (1995/96 ed.). The decision in this case implies nothing about the tax treatment of other business expenses.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

SETH P. WAXMAN
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

KENNETH L. GREENE
THOMAS J. CLARK
Attorneys

NOVEMBER 1997